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RISK & INSURANCE® INDUSTRY RISK REPORT: MIDDLE MARKET



CONSTRUCTION AND architect and engineer firms largely fit into the definition of middle market for most carriers, and usually make up one of the specialties that only certain insurers dare to write.

FINDING FAT IN THE MIDDLE

The middle market is calling again, and insurers are a comin'. Are they stumbling into another bloodbath, or are they in control of the battlefield this time? ● BY MATTHEW BRODSKY

"The middle market, in my opinion, was the killing field for a lot of carriers in the '90s," says John Hennessey, senior vice president, middle market and casualty underwriting, at Chicago-based CNA Insurance.

Lost pricing discipline, ramshackle risk selection, misadventures into the specialty fringes—today's insurers can still hear the cries of the ghosts of markets past, the likes of the Kempers and the Reliants. But are they listening?

The call of quick cash might be too enticing. The middle market represents wide-open space, whereas the *Fortune* 500 is confined to, well, 500 insureds. According to insurance executives, the middle market ranges in size from \$55 billion to \$120 billion.

"That's pretty hard to ignore," says Bill Cunningham, president and CEO of Travelers commercial accounts, who estimates his company's middle-market stake at \$6 billion. "Frankly, it's a space where we make a hell of a lot of money."

The middle market also allows national standard-lines carriers to spread risk where the threat of big claims is less pervasive, where the loss of an account won't lead to heads rolling, says Michael A. Mayers, senior vice president, risk management services, at business-services provider CBIZ Inc.

But cash is king, especially in a softening market. Say big carriers cut 10 percent off the price of

their national accounts. They need to make that 10 percent elsewhere, says Beth Malone, managing director, equity research analyst, KeyBanc Capital Markets Inc. Elsewhere is the middle market.

Then there are carriers aiming straight for top-line market-share growth, underwriting discipline be damned. Another war with much premium spilled, reminiscent of last decade, could ensue.

For the moment, Gary Thompson, who leads The Hartford's middle market effort, has heard only a horror story here and there. Overall, insurers are not dabbling in irresponsible underwriting in 2007, he says. They're locking horns in legitimate price competition and adjusting terms and conditions.

Yet other executives state that the 2007 middle market seems like no other, and not in a good way. Says Hennessey, "We've never seen a competitive marketplace like we see today."

The answer to the discrepancy is simply that this softening middle market is unlike any other.

For starters, underwriters have stacks of chips to play with because of last year's historic profits. They need somewhere to put that money. "Unallocated capital is not a good thing," says Dennis Marvin, underwriting executive with Fireman's Fund.

There might be more room to allocate it this go around. "There's a long list of carriers that aren't here today that were certainly strong players not 12

years ago," says CNA's Hennessey.

Regionals and superregionals fill the vacuum, like Selective, State Auto, General Casualty, Cincinnati, Westfield and Harleysville. They join nationals of the likes of the Hartfords, Chubb, Travelers, AIGs, Wausaus and Affiliated FMs.

All are armed to the teeth with the latest technologies in pricing and expense models, to slice and dice their way to more market share.

Meanwhile, where does this new soft market leave the insureds? In certain respects, they're in the same place they always are when the cycle goes from yang to yin.

"During soft markets," says Larry Williams, vice president, middle-market division, at Columbus, Ohio-based regional State Auto Insurance Co., "the nationals (carriers and brokers) now they love them. When they really want to be loved is in the hard market."

But in other respects, middle-market policyholders aren't in the usual position, passively seeking carriers' affection. Now they've learned to play the field like the heroine in a chicklit novel.

The traditional maxim that middle-market retention rates are higher is "being tested as we speak," says Jim West, senior vice president at Chubb & Son. "They will stay with you and they appreciate your value so long as you provide value, but if you don't continue to provide that value, they're far more comfortable I think finding a new solution."

"All they know is, if they don't like what they have, they're going to go out and there's always somebody out there that will give them something else," says risk management consultant Mayers.

The recent "Insurance Market Pulse" from Greenwich Associates bears this out. The consultancy found about one in three middle-market and small-business policyholders changed insurers in the last two years. These middle-market clients saved a median of \$25,000 off premiums. (Visit our Web site for more on the findings.)

This dating game isn't all about chasing lower premiums. The sophistication of risk management that many middle-market companies practice, especially at the top half of the pack, drives the churn too. Whether it's the CFO or somebody else in treasury buying insurance, they know how to mitigate their risks and what services they cannot provide for themselves. Specialized risk control, reports and claims services are "table stakes" to get and retain these customers, say insurers.

Upper-end middle-market clients also are increasingly requesting coverage previously reserved for national accounts, such as privately held companies looking for directors' and officers' or manufacturers with tough products exposure, says Bob Lindemann, president, middle markets, for Zurich North America Commercial. They could be expanding globally and taking on international risk through more foreign sales, the acquisition of hard assets or involvement in foreign stock exchanges.

"Today, most middle-market companies have some exposure overseas," says Chris Maleno, president of Ace USA regional operations.

Such global reach leads insureds to seek business-interruption and contingent BI, says Carol Barton, senior vice president, commercial lines, at Affiliated FM, middle-market arm of property insurer FM Global with \$650 million in gross premium written last year.

Carriers aren't acting according to the old script either. Regionals used to court smaller fish for whom price competition's less fierce. It used to be they offered customized products and local relationships.

Nationals used to bring to bear massive underwriting and technological resources for the

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bigger fish, while still providing “off the shelf” products.

FLIP-FLOP

Change in this dichotomy is apparent. Not to say the revolution has already been televised, but in some respects, national carriers are behaving like regionals had, and regionals are talking like nationals.

For instance, some nationals seem to be aiming for the smaller end of the market. CNA, according to Hennessey, is doing just that because rates there tend to hold in a soft market. Prices drop off faster on the upper end, he says, perhaps because of the “allure of the premium.”

Meanwhile, regionals are chasing that big money.

“The regional carriers, who 15 years ago really stuck to their knitting in the under-\$100,000 account size risk—now you’ll see regional carriers much more actively pursuing accounts all the way up to \$500,000 or \$700,000 in premium,” Hennessey says.

Don’t take this wrong. Regional carriers are still limited by geography and finances, and they still feel their upside to be neighborly relationships with both agents and insurers.

Many nationals still are a one-stop-shop, cross-selling machine for their clients. For them, the old adage is still true that, as risk management consultant Mayers puts it, “carriers want to be all things to all people.”

But in the 21st century middle market, regionals are talking this bigger game too.

Ed Pulkstenis, chief commercial lines underwriting officer at superregional property/casualty carrier Selective, which wrote \$1.5 billion total business in 2006, mostly middle market, uses the word “generalist” to describe how it writes across 80 difference sectors.

“We’re seeing a movement away from saying, ‘I want classes a, b, c, but I don’t want classes x, y, z,’” he says. “Companies are trying to write the best business in more classes.”

Williams at State Auto says much of the same: “We avoid target classes. We don’t want them. We’re against it.”

And in this 21st century middle, the big carriers are branding themselves as “local.” While Thompson notes how in the last 10 years Hartford has consolidated what had been a siloed operation, for

instance, he mentions that this new structure is built around specialized underwriting and local distribution.

“It’s important if you align with your agencies the right way, locally,” he says.

Tony Ciofani, chief underwriting officer at PMA Insurance Group, says his employer is a regional carrier with a national scope, differentiated by its “local branch offices.”

Susan Doyle, executive vice president for field operations for national commercial property/casualty carrier Wausau Insurance Cos., a member of the Liberty Mutual Group with \$1.3 billion in premium last year, mentions how the insurer just recently restructured its operations to place a greater emphasis on agents and brokers than industry segments.

While industry expertise is important, the middle market is based on relationships, she says.

The U.S. arms of international carriers also want in on these relationships. Lindemann points to Zurich’s local offices in Houston; Minneapolis; Pittsburgh; Charlotte, N.C.; and Long Island. Bermuda companies, such as Ace, Arch and XL, are all striving to differentiate themselves with their nets of local U.S. branches and local agents.

Such involvement can mean not just the need for a local presence, but highly dedicated local agencies.

“Specialized agents have the lock on the knowledge,” says John Glancy, chief underwriting officer, global professional, for XL Insurance.

THE FRINGE ELEMENT

That leads to another word that national carriers have co-opted to describe their operations—“nimble.” Nimble might not be the word to describe a massive insurance enterprise, but admitted and nonadmitted carriers trawling for business need to be agile, they say, because the middle market is not homogenous in the least. It’s a motley quilt of patterns—of geography, of line—within sectors ranging from construction to technology, health care to finance, retail to real estate.

“The middle-market business is very fractured,” says Wausau’s Doyle.

In such complicated space, even national carriers realize they have limitations—or specializations, they

might say.

“You start to find that carriers, whether they want to or not, end up sort of pigeonholing themselves into certain kinds of places in the marketplace,” says Mayers.

West at Chubb relates how he had the revelation that Chubb was a “niche” player in the middle market, and that its property/casualty business was really a “compilation” of specialties. John Edack, executive vice president at Arch, speaks of the need to “bob and weave” among all the folds and nuances of the market.

For carriers that float like a butterfly among these specialties, the word of choice to explain what they’re providing clients is “value.” Rates are downplayed.

“Our specialized focus on certain industry segments has helped insulate us from the current cycle,” says Drew Carnase, senior vice president of commercial lines at One Beacon Insurance Group Ltd., adding that it allows the Bermuda-based company “to tailor products and services for these customers which often make price a secondary concern.”

Prices are primary to someone, though, right? Yes, the other guy. It’s always the other guy cutting prices to lure in bargain-hunters.

It’s the other guy doing underwriting yoga to stretch market share into sectors about which they have no clue, for risks in the fringes where standard lines blur into surplus lines.

This other guy’s busy.

Michael Stone, president at Peoria, Ill.-based specialty insurer RLI Corp., is seeing the effects of the other guy. “Less business is available for those of us hanging around trying to pick up the good scraps.”

“They are now going after that business in a much more aggressive fashion,” agrees Rich Aldoriso with surplus-lines stalwart Markel Underwriting Managers, adding that some of this national-carrier capacity is coming in “naïve.”

“Besides the top-line growth,” he says, “these national carriers could be stepping into the edges of the E&S market because they don’t believe the soft market will last very long. A move into these sectors will be a beachhead that they’ll use to grow exponentially from there once the

market revolves.”

The tactic has touched some classes more than others. For example, the law-firm sector—that’s hot, to paraphrase Paris Hilton.

“The lawyers market has never been softer, or more competitive, or more perilous for the carriers,” says Mark Henderson, product manager for lawyers and architects and engineers at Shand Morahan & Co., Inc., the underwriting manager for Evanston Insurance Co. and subsidiary of Markel Corp. in Richmond, Va.

The reason is that the lawyers segment is a “quick and easy place” to get premium. He says some standard admitted carriers are already “blindly” cutting rates, leaving less out there for the hard-to-place markets—and this despite the fact that the level of frequency and especially severity is at an all-time high.”

Part of the explanation lies with the lawyers themselves, says Henderson, because they are “much more price and premium conscious.”

“There are segments that don’t care about value added,” says XL’s Glancy.

There are some that do. Architects and engineers demand loss control and claims expertise from carriers, which can be an impediment to “copycat, me-too-type” entrants trying to “burn their way in,” says Henderson. It’s the “longer-term market players” that still predominate in such a complex industry.

This contest between the copycats who provide cut-rate commoditized products and longer-term players and their added value is telling of the entire middle-market picture, not just the fringes.

In that regard, maybe the market of 2007 is not so different than previous ones. So, then, will we be back in the killing fields in no time?

“We continue to do the stupidest things, we do dumb things all the time,” says Mayers.

Others are more confident. “It would take a real true level of ignorance to get as stupid as we have in the last cycles,” State Auto’s Williams says.

MATTHEW BRODSKY is associate editor of Risk & Insurance®. He can be reached at mbrodsky@lrp.com.

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